CFOLC TOOLS LIBRARY

Lease liabilities Negotiation Options

This best-practices document shows how numerous CFOs are negotiating lease liabilities with lenders.

Q. One of my financial covenants is leverage which divides total debt minus cash by trailing 12 months adjusted EBITDA. When we implement ASC 842, our liabilities and debt will go up significantly and cause a failure of this covenant. Has anyone else come across this, and how are you addressing with your lenders

The definitions in my loan agreements will require me to add this liability, so I'll need to renegotiate.

- Confirm that the lease liability meets the definition of debt under the credit agreement. I have seen some CAs that define debt narrowly or broadly. If it does meet the definition, I would talk with your lender. Everyone has the same issue. My lender had no issue excluding it from the calculation so long as we continue to push the expense through EBITDA and not try to group it a depreciation and an extra add back.
- I used to be a lessor and we had warned clients about this when 842 was coming along. From what I had heard secondhand was that most banks modified their covenants for this specific situation. I'd go back to the banks and ask if they are changing the formula or calculation. Unless your bank is looking for an excuse to part company, you should be fine.
- I have been working for a Chicago based PE fund and some have had to renegotiate debt covenants to address this topic.
- My suggestion would be to consider revisiting the definition with your lender to either readjust the multiple so that it's in line with what's expected now that you are hanging these liabilities on your balance sheet OR have the definition exclude these all together.
- The operating lease liabilities (Short-term and Long-term) are not debt. They are a liabilities. If you look in the definitions of your bank agreement you will probably find that the definition of debt includes "borrowed money." You did not borrow any money to fund the operating lease

liability. Having said that, our bank put a new leverage covenant in place to include the total operating lease liability. They let us include rent expense in the EBITA calculation, which is now called EBITDR.

- We negotiated with the bank to use "EBITAR" instead and added back actual lease payments. They still count as liabilities, but we aren't double hit by also having the expense reduce earnings.
- Have you looked into the loan language around non cash /accounting standards?
- Worth exploring with the lender, they may come back and tell you they don't really care about this standard for covenants calc purposes.
- Not sure what you've received so far and don't quote me on this, but check into the fine print of the covenants/loan documents. Most of the time there are provisions to safeguard against changes to accounting code/rules/etc. In this event, you won't be the only one that is dealing with it.

(Source: CFOLC)